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The Manufacturers Hanover
Economic Report

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The Fed's Dilemma

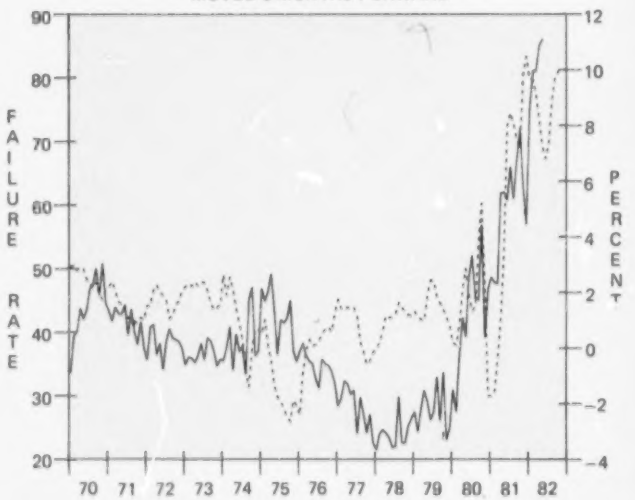
Unable to draw up a plan for spending and taxes that would convince the financial markets that they have control over the budget process thus enabling interest rates to decline, some elected officials in both the Administration and the Congress have turned their attention to the Federal Reserve. The Reagan Administration is reportedly considering proposals that would restrict the independence of the Fed. For its part, the Joint Economic Committee recently held hearings discussing the conduct of monetary policy with the intent of determining what could be done to bring interest rates down fairly quickly in order that the economy might recover from its prolonged slump. Not surprisingly, the Federal Reserve was widely criticized for its performance. While the Fed is no stranger to criticism, it seems to be more intense than usual.

The critics divide into two camps. Those who follow the so-called monetarist view complain that the Federal Reserve has once again strayed from the path of righteousness. They believe that the Fed's credibility as a devoted inflation fighter is in question because the money supply has grown faster than this year's maximum target. On the other hand, the central bank is being criticized with equal vigor by many elected officials in the Congress, a few in the Administration, some nonmonetarist economists—not to mention a growing chorus of businessmen--for being too restrictive with money growth. About the only thing that everyone agrees on is that interest rates are too high (see Chart I) and that, somehow or other, the Federal Reserve can do something about it.

To Bring Interest Rates Down ...

The Federal Reserve's dilemma is that it can't—at least not without some fancy footwork. Thanks to the rise of monetarism and its influence on the financial markets, the Fed can no longer control interest rates the way it used to. To be sure, the Fed could push short-term rates down by purchasing government securities in the hands of banks and dealers thereby injecting liquidity into the economy. But this would be a short-lived solution if it were to produce growth in the money supply faster than that called for by the Fed's target range. Ultimately, the markets would bid up interest rates, reflecting either the anticipation of future tightening by the Fed, or the inflationary consequences of too much money growth.

CHART I
INDEX OF BUSINESS FAILURES PER 10,000 FIRMS (LINE) VS. REAL PRIME RATE, MOVED 6 MONTHS FORWARD



On the other hand, if the Fed were to strive vigorously to bring the money supply into its target range, it would run the risk of exacerbating an already precarious economic situation. There is no doubt that business liquidity is drying up at an alarming rate. Corporate balance sheets are weaker than at any time in postwar history —thanks in good part to the sudden disappearance of inflation. Unable to adjust to zero inflation after years of steadily rising prices, most businessmen find that they are still geared for an inflationary environment. This means that their costs—including the cost of money—are rising faster than selling prices. Lower interest rates would help business make the transition to a less inflationary environment; right now this does not seem to be in the cards. In the meantime, deteriorating financial conditions appear to be claiming larger and larger victims. Tightening monetary policy in order to slow money growth would only worsen this trend and raise serious questions as to the viability of large segments of the private sector.

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As I see it, there are two problems here which need to be solved. The first is to bring interest rates down, while the second is to convince the markets that the first will not be accomplished at the expense of fighting inflation. There are several ways in which interest rates can be reduced consistent with maintaining an anti-inflation posture. First and foremost is the need for an agreement between the Administration and the Congress to reduce the Federal budget deficit for fiscal year 1983 and beyond. Only after the financial markets see a series of credible deficit figures showing a declining trend will their fears concerning the government's future borrowing needs be assuaged—permitting interest rates at all maturities to fall closer to normal levels relative to inflation.

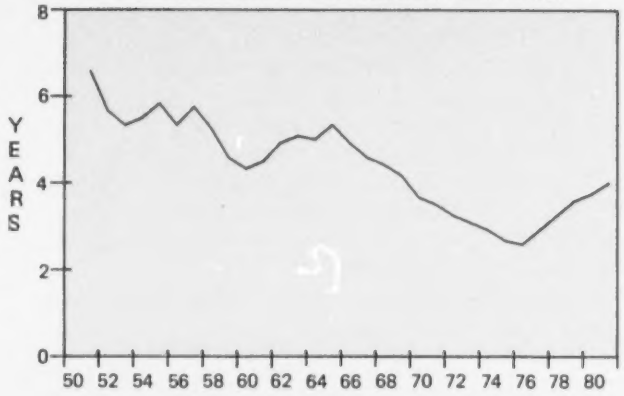
Not long ago several steps were taken in this direction by the two houses of Congress resulting in a projected budget deficit for 1983 of a little over $100 billion. However, many in the financial markets are skeptical that the Congress will be able to adhere to even this record number. The economic assumptions have been called unrealistically optimistic. Spending levels have been assailed as understated, while revenue expectations have been termed overestimated. In addition, there are concerns that the inevitable political pressures will cause even more spending and less revenues, once the various constituencies see how their programs have been impacted. Furthermore, there remain the budgets for 1984 and 1985—which require even deeper slashes in spending and/or greater revenue "enhancements" in order to drive the deficit down further. What I am saying, in other words, is that this process, as fundamental as it is, may take a while before it produces the results that the financial markets want to see. Yet, time is of the essence, so we must examine the other possible ways to bring interest rates down.

. . . The Treasury Should Sell Bonds . . .

Because it is such a major factor in the financial markets, the Treasury affects interest rates by virtue of the volume of securities offered to the markets, as well as the maturity areas in which it borrows. Although it has long been the intent of the government's debt managers to lengthen the maturity of Washington's debt—that is, sell securities with the longest possible maturity dates—for a variety of reasons they have not, with the result that the average maturity of the Federal government's debt has fallen to only four years (see Chart II). Plainly, this means that Washington must borrow incessantly, not only to finance current needs, but to pay off earlier obligations as well. This huge (and obviously growing) demand for short-term funds by Washington is a key reason for short-term interest rates being as high as they are today.

It would thus seem logical that Washington should consider selling securities of long-term duration. To be sure, this means that Washington will be locking in

CHART II
AVERAGE MATURITY OF TREASURY SECURITIES



costly, non-callable long-term funds. But it could have salutary side effects by reducing demands for short-term credit. This alone might depress short-term interest rates to a level well below rates in longer maturities. Such a positively-sloped yield curve would confront investors with a substantial penalty for committing their funds to short-term money market instruments as opposed to longer-term securities. If this penalty were enough to offset current fears of future inflation, as well as of the likely course of fiscal and monetary policy, a substantial portion of investors would once again lengthen the maturity structure of their assets. As more cash flows into longer-term instruments, interest rates would begin to drop, opening up an opportunity for business to access the longer debt markets. To the extent that business can borrow in the longer-term markets these days, it will use these funds mostly to pay off short-term debt—in the process keeping the yield curve positively sloped.

The process of "twisting" the yield curve to a positive slope would be helped if the Federal Reserve were to pump a little more liquidity into the economy. The Fed has done this before, the most recent instance being autumn, 1981. At that time, however, the money supply was growing *below* the 1981 target ranges, so the markets were not unduly upset when they saw the Fed injecting additional reserves into the banking system with the intent of speeding up money growth. Indeed, interest rates fell as the money supply grew more rapidly, reflecting, for once, the usual liquidity effect: i.e., more money in circulation depresses its price. However, the Fed does not have that luxury today, since, as you can see from Chart III, the money supply is growing *above* its target path. Unless the Federal Reserve can convince the markets that faster money growth does not mean abandoning the fight against inflation, any contribution it might make toward twisting the yield curve positively would backfire.

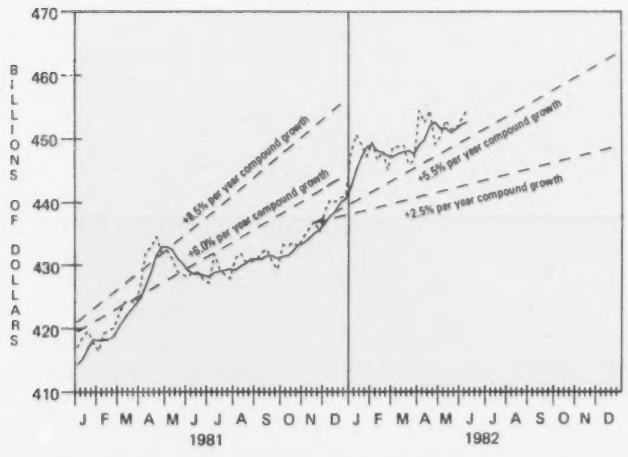
. . . While the Fed Eases a Touch

In my view, the Fed can justify adapting a somewhat easier money posture. One way to accomplish this might be to remind the markets that, however worth-

while it might be to aim at a low enough rate of money growth consistent with fighting inflation, such a process need not be followed week in and week out. Most economists would agree that transitory fluctuations in the money stock cause little or no problems in and of themselves, provided that they are offset within a reasonable period of time. As Paul Volcker, Chairman of the Federal Reserve Board, recently said in Congressional testimony, "We need also to be conscious of the fact that the world as it is requires elements of judgment, interpretation and flexibility in judging developments in money and credit and in setting appropriate targets."

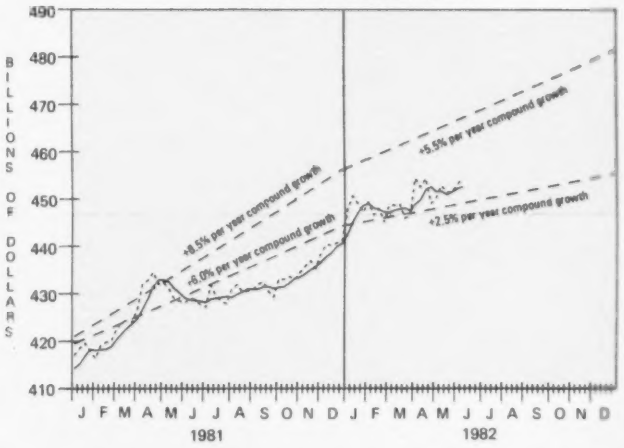
Critics of this proposal would argue that all they have seen in recent months have been "transitory" fluctuations and that they are unsure at any one time as to whether the Fed is either able or willing to keep money growth under control. To this I would point out that over longer spans of time the growth of money has been restrained. From fourth-quarter 1979 through first-quarter 1982, the money supply M-1 grew at a 6.6 percent annual rate—down from the 8.1 percent dip of the previous ten quarters. Quoting Paul Volcker again, "This longer-run and broader perspective is what should be kept in mind when considering growth in the aggregates." He went on to say that the Board's decision to publish the money supply data in the form of four-week moving averages is designed to divert attention from the statistical noise inherent in the weekly figures and to encourage people to focus on the broader trends.

CHART III
MONEY SUPPLY, M1
FOUR-WEEK MOVING AVERAGE (LINE)
VS. WEEKLY FIGURES (DOT)



I think this is a good idea, but would go one step further. In my opinion, monetary policy cannot simply focus on one aspect of the economy—the rate of inflation. It must also focus on the "real" world. And while inflation has been subdued, many companies are going down for the third time, thus need help quickly in the form of lower interest rates and greater availability of money. The Fed could provide this without unduly alarming the financial markets. All it need do is reposition its growth targets for 1982 as suggested in Chart IV. As you can see, the lower band still slopes upward at 2½ percent compound growth per year while the upper rises at 5½ percent per year. In this regard, the targets are unchanged. What is different, obviously, is the fact that they don't begin from the *average* of the money supply in the fourth quarter of 1981. Rather, they begin as an *extension* of the target bands for the year 1981.

CHART IV
MONEY SUPPLY, M1
FOUR-WEEK MOVING AVERAGE (LINE)
VS. WEEKLY FIGURES (DOT)



I can offer two lines of defense for reconstructing the 1982 targets. For one thing, there is no hard and fast rule that I know of that says that the point of a year's money growth targets must begin with the average for the fourth quarter of the previous year. Because the money supply undershot its 1981 targets but was rising toward yearend, it stood to reason that, no matter what the weekly wiggles were, the money supply would start out the new year above target—which, indeed, it did (see Chart III). Had the money supply accelerated back in August or September of 1981—then flattened to its January-February 1982 levels—the 1982 growth targets would be in approximately the position I have shown.

Business Needs More Liquidity

Of course, for all this to be accepted by the markets, the Fed should point out that this is not being done in the context of accelerating inflation. Rather, this change would be made in an era of little or no inflation. Referring to the growth in the money supply over a longer span of time, Chairman Volcker said "The restrained growth has, in my judgment, contributed importantly to the now clear progress toward reducing inflation." In other words—this adjustment would be undertaken not to validate inflation, but rather, to provide a little liquidity for the real economy to revive.

While this adjustment is suggested to assuage the fears of those in the financial markets who place great faith in monetarism, it should be pointed out that this is

not intended to suggest that monetarism must be followed blindly week in and week out. Furthermore, to the extent it is useful at all, monetarism will produce optimal results only when monetary and fiscal policies are in harmony—and not at opposites as has been—and is still—the case.

The evidence of the past few years makes it clear that tight money can indeed bring down the rate of inflation—but only at the expense of subduing the real economy as well when fiscal policy requires the Federal government to increase its borrowings in the financial markets. To be sure, there will always be some pain associated with slowing inflation. However, the pain we are suffering is the worst since the 1930s and must be alleviated before it leads to a repetition of the 1930s. And I cannot stress too strongly that time is important: The economy cannot take too many more months of interest rates at these levels. M

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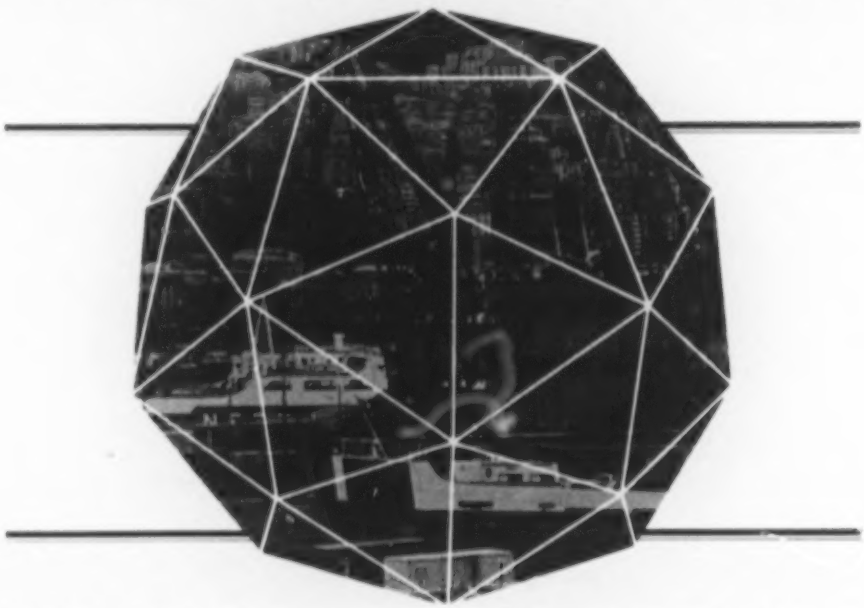

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